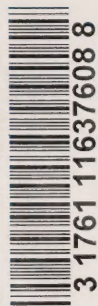


CA1  
MH  
- 1997  
H55



# Home Ownership Loans **Borrower** **Eligibility**

A guide to help you assess borrowers.



Digitized by the Internet Archive  
in 2023 with funding from  
University of Toronto

<https://archive.org/details/31761116376088>

# Table of Contents

<b>Application</b> .....	1
<b>Preliminary Analysis</b> .....	1
<b>Minimum Documentation</b> .....	2
File Documentation Is Key .....	2
<b>Employment and Income</b> .....	2
Employed by Others .....	2
Self-employed .....	2
<b>Eligible Income</b> .....	3
Commuting .....	3
Overtime/Secondary Employment .....	3
Commission Income .....	3
Bonuses .....	3
Tips .....	3
Self-employed .....	3
Rental Income .....	3
Investment Income .....	3
Alimony/Child Support .....	3
Social Assistance/Employment Insurance .....	3
<b>Affordability Ratios</b> .....	4
<b>Gross Debt Service (GDS) Ratio</b> .....	4
Secondary Financing .....	4
Condominium .....	4
<b>Total Debt Service (TDS) Ratio</b> .....	5
<b>Equity</b> .....	5
<b>Verification</b> .....	6
Applicant's Savings .....	6
Sale of Another Property .....	6
Sale of Stocks/RRSP .....	6
Gifts .....	6
Borrowing Against Assets .....	6
Land .....	6
Sweat Equity .....	6
Rent as Equity .....	6
Equity Grants .....	6
Closing Costs .....	6
<b>Credit Worthiness</b> .....	7
Credit Report .....	7
Net Worth .....	7
Non-Residents of Canada .....	7
Guarantors .....	7
<b>CMHC Information Products</b> .....	8

# Introduction

Government  
Publications

**A**SSESSING A BORROWER is considered the most difficult task in the review of home ownership loans. It involves not only the collection and analysis of data, it also requires the application of sound judgment in an environment where it is difficult to obtain complete and accurate information within tight deadlines.

This publication covers the *major areas and issues of borrower assessment*. Given the number of variables and individual circumstances which come into play, it is impossible to cover all contingencies.

If, however, you feel there are issues which seem to recur but have not been addressed, please discuss them with the Director, CMHC Insurance Products Division, or with your local CMHC representative.

Also provided at the back of this publication are a list of useful CMHC Information Products and a directory of all CMHC offices.





## Application

This advisory document outlines the process to be followed for high-risk loan applications. Obviously, there will be instances where it is clear that factors relating to either the property or the borrower indicate that the mortgage offers acceptable risk. In such cases, the underwriter need not explore all aspects of the borrower's financial capacity in as much detail as indicated here. Such action is considered to be normal and prudent, provided that the lending decision is made from a position of knowledge and is supported by sound judgment.

## Preliminary Analysis

The underwriting of home ownership loans involves a review of the market, an assessment of the borrower, a review of the property, and a synthesis of the three into a final risk assessment.

Preliminary data on the applicant are generally provided through an application form. Subsequent steps focus on VERIFICATION of the data supplied in support of the application and an ANALYSIS of it to determine the borrower's acceptability.

In assessing a borrower, underwriters should ask themselves the following questions:

- Are the proposed payments manageable?
- For shorter-term mortgages, could the borrower cope if the loan was renewed at a higher interest rate?
- Is income likely to be stable and continuous over the next three years?
- Is there good history of credit management?
- Does the borrower have a net worth reflecting prudent financial management?
- What is the source and the amount of the down payment?
- Is the information accurate and consistent?

The underwriter should ensure that the rationale leading to the lending decision is evident to any observer.

## Minimum Documentation

### File Documentation Is Key

A properly documented file should contain the following:

- verification of employment and income;
- verification of the source and amount of equity;
- credit report; and
- underwriter's analysis and rationale for decision.

The form and detail of this documentation may vary depending on the underwriter's assessment of the characteristics of the borrower, the property, and the market in which the property is located.

## Employment and Income

The reason for reviewing the employment and income of applicants is to assess whether their incomes are sufficient to meet their obligations under the mortgage.

### Employed by Others

In general, employment and income should be confirmed by a letter from the employer stating length and type of employment, (i.e., contract, probation, regular) and salary with and without overtime. Oral verification of income and employment is acceptable provided due care has been taken to ensure that the information provided is accurate. Normally, an oral verification is acceptable if the underwriter contacts the individual's employer or immediate supervisor and the loan file is documented with the name, telephone number, and position title of the person providing the information as well as the information provided by the borrower.

Underwriters should exercise caution when they suspect the person providing the information does not have an arm's length relationship with the borrower. If there is any indication that such a situation exists, underwriters should get additional supporting documentation such as income tax receipts or payroll stubs.

To demonstrate the necessary stability of employment, borrowers should have been continuously employed by their current employer for at least one year. Applicants who are on probation or on short-term contracts should not normally be considered.

Where doubt exists, the stability of the employer should also be examined to ensure there is reasonable probability of the firm remaining in business and thus being able to offer continuing employment.

### Self-employed

Self-employed applicants should normally be able to demonstrate at least three full years of successful operation. This is to be verified through either a review of the financial statements of the business or the individual's income tax returns. If income tax returns are used to verify income, they should be supported by the official receipt of a Notice of Assessment from Revenue Canada.

The borrower's income alone, or in combination with that of a co-applicant, must be sufficient to cover not only the mortgage debt and property expenses but also other debts, and still leave sufficient cash for day-to-day living.



# Eligible Income

The following matters should be considered when calculating an applicant's/co-applicant's gross income:

## Commuting

If the place of employment is not within typical commuting distances, the underwriter should assess the reasonableness of the application, as well as the income.

## Overtime/Secondary Employment

Income earned on overtime should be included only if it is clearly demonstrated that such income is typical and that the amount of overtime is reasonable and is expected to continue. The same holds true for secondary employment.

## Commission Income

Commission income may be included if it can be clearly demonstrated that the level of income is supportable in the future.

Generally, this would require the borrower to demonstrate that similar commissions have been earned in the past three years.

## Bonuses

Bonuses and/or profit-sharing allowances may be included in the income where they can be verified for the past three years at similar levels with the likelihood they will continue in the future.

## Tips

Tips and/or gratuities may be included provided they have been declared as income and verified by an official tax receipt.

## Self-employed

Self-employed individuals must clearly demonstrate the existence of the necessary profits for the borrower to withdraw the income indicated. Income tax receipts on their own are not generally sufficient.

## Rental Income

The net income (actual rentals less operating expenses), up to 50% of the gross income, may be added to a borrower's income. If operating statements for the property are not available, expenses may be estimated to be 50% of gross rentals.

**Note:** Payments on mortgages or other debts related to the properties are not part of the operating expenses. If the property being purchased is intended to be used solely for rental, net income from it may be added to the borrower's income, in accordance with the above, if there is reasonable expectation that the income will continue.

## Investment Income

Income from investments in securities, bonds, and so on may be included if it can be demonstrated that such income has been available for the past three years and such income is reasonably expected to continue. However, if the income is of a speculative nature, it should not normally be included.

## Alimony/Child Support

Payments for alimony and/or child support may be included as income where it is demonstrated that such payments have been fully and regularly made and are expected to continue on a regular basis.

When the applicant is the person making alimony/support payments, whether or not such payments are actually made, the required amount of payment(s) should be deducted from his/her income.

## Social Assistance/Employment Insurance

Payments from social assistance and employment insurance are normally included only if they represent typical cyclical income patterns and are likely to continue in the future.

## Affordability Ratios

Both the Total Debt Service (TDS) and Gross Debt Service (GDS) ratios are considered as rule-of-thumb indications only. An applicant's ability and desire to repay a loan is dependent, to a large extent, on lifestyle and past spending habits. These should be explored if possible to ensure that the conclusions arrived at through the use of the ratios are reasonable.

Lenders and mortgage insurers may have specific policies regarding TDS and GDS calculations, including the maximum ratios allowable. Underwriters should refer to their policy manuals in this regard.

## Gross Debt Service (GDS) Ratio

The Gross Debt Service (GDS) ratio shows the relationship between debt service and income. It is the ratio of a borrower's income to payments on the house. The payments typically include First Mortgage Payment, Property Taxes, and Heating Costs, as well as the following:

### Secondary Financing

The repayment of any other financing on which the property has been provided as security (that is, all types of secondary financing such as loans from relatives, lines of credit) is included in the GDS ratio.

### Condominium

The GDS ratio typically includes 50% of the estimated condominium fees, as these are not considered discretionary expenditures.

For high-ratio financing, a GDS ratio of up to 32% can be approved by the underwriter. Higher GDS ratios may be considered with supportive analysis. Such analysis may include a detailed budget for the applicant, along with verification of items used to offset this weakness.



## Total Debt Service (TDS) Ratio

Since most borrowers have to meet financial commitments other than shelter costs, their financial capability to meet all obligations is assessed on the basis of Total Debt Service (TDS) ratio, which relates the carrying costs of both shelter and consumer debt to gross income. A TDS ratio up to 40% is generally the maximum that a borrower can have without additional supportive analysis.

Borrowers receiving net income from other real estate unit(s) in the property being purchased, or rental of the property being purchased, should be reviewed on a basis of 40% TDS, after giving consideration to the rental income received, as well as payments on the debts relating to the property(ies). Care should be exercised to not include property taxes in the TDS calculation if they have already been deducted as part of operating expenses.

## Equity

The greater the amount of equity applicants have invested from their own resources, the less chance there is that they will default on their mortgage. The underwriter should ensure that the borrower is fulfilling the minimum equity requirements of the Approved Lender or insurer.

The underwriter should be satisfied that the equity will be available at the time of closing and will be invested in the property.

"Own resources" is interpreted to mean bona fide savings, an outright gift from an immediate relative, borrowing against an equivalent amount of proven assets (see definition below), equity from the sale of another property, and/or applicant labour.

The underwriter must be satisfied that, in addition to the minimum equity requirement, the borrower can pay the required start-up and closing costs. These include, but are not limited to, professional fees, deposits, land transfer and registration fees, new home warranty insurance premium, etc.

### Definition of a proven asset:

*A proven asset is any asset which is unencumbered by debt, is readily convertible to cash, and is securable.*

*Financial assets such as cash, GICs, Certificates of Deposit, Savings Bonds, Treasury Bills, common and preferred shares, MBS certificates, mutual fund investments, cash value of whole life insurance, and other marketable securities meet the definition of a proven asset. Financial assets, such as stock options, which are of an extremely volatile nature are not considered proven assets.*

*A proven asset which is not financial in nature should be easily sold and readily convertible to cash at the value indicated. The following are not considered to be proven assets: personal effects such as clothing and furniture, automobiles, equipment, jewellery, patents, receivables and IOUs, goodwill, foreign assets, and unused tax credits.*

# Verification

## Applicant's Savings

Underwriters should attempt to obtain statements showing accumulation of the savings in an orderly and reasonable manner. Applicants normally could not save the necessary down payment over two or three months unless there were special circumstances. Savings should be compared with income to ensure that they are reasonable. The savings should also be checked against the credit report to determine if the date of any large deposits coincides with credit enquiries. Affidavits or declarations obtained from borrowers stating that the equity is from their own resources are not sufficient by themselves.

## Sale of Another Property

If equity is to come from the sale of another property, verification of this equity should be obtained. The underwriter may have to obtain a statement of the outstanding balance on any existing financing on the property. A listing of existing financing may be acceptable if the Approved Lender finds it reasonable.

## Sale of Stocks/RRSP

If the down payment is to come from the sale of stocks or bonds, the underwriter should verify their market value. If the equity is to come from the collapse of a registered retirement savings plan, the impact of taxes payable on collapsing the plan must be assessed.

## Gifts

Outright gifts from immediate relatives are normally an acceptable source of equity. Since these do not represent arm's length transactions, care must be exercised to verify the authenticity of the transactions.

Furthermore, these gifts must be documented by a letter from the donor which confirms that the money is a true gift, not a loan.

## Borrowing Against Assets

Applicants may use other assets as security for loans that will be used for the required equity. Underwriters should ensure that the value of the asset supports (and will continue to support) the loan provided, and that payments on the loan are taken into consideration when calculating the TDS ratio.

It is normally acceptable for applicants to borrow against potential bonuses or future revenues derived from profit-sharing plans, if their payment and value are confirmed.

## Land

The paid-up value of land may be considered as equity, provided the underwriter is satisfied with the value of the land and the balance of any outstanding encumbrances.

## Sweat Equity

The underwriter must be satisfied that the applicant has the necessary skills and time available to perform the work within an acceptable time frame. When there is a construction agreement with a builder, the "sweat equity" is to be clearly provided for.

The allowance for "sweat equity" should not normally exceed half the required minimum equity.

## Rent as Equity

Rent should only be accepted as equity if it is acknowledged in a contractual agreement that includes the prepayment of equity on a monthly basis, as part of an agreement to purchase. This would, however, involve the monthly payment of an amount in excess of the current market rent for the property and would also include at least a partial refund in the event that the prospective purchaser did not exercise his/her right to buy. The amount of equity credited to the borrower should only represent the sum of the amounts by which monthly payments exceed the market rent for the property.

## Equity Grants

From time to time, governments introduce housing assistance programs. In such cases, underwriters should refer to the Approved Lenders' or insurers' policy manuals to determine their treatment of these.

## Closing Costs

The underwriter must verify that the borrower has the resources to cover closing costs.



# Credit Worthiness

## Credit Report

A report on the borrower(s) must be obtained from an independent credit-reporting agency in sufficient detail to confirm:

- current address, borrower identification;
- loan and payment records, credit history; and
- recent enquiries.

There are various types of reports provided by a credit bureau. The type requested should provide current file information on credit received and current outstanding balances.

To the extent possible, recent enquiries noted in the report should be investigated to determine if additional credit was granted that is not reflected on the file.

If borrowers have been known to use several names, nicknames, variations in spelling, birth names, or previous spouses' names, credit reports should be obtained on all of them. Similarly, if an applicant has moved in the last few years, a credit report should be obtained from the previous place of residence, as well as the current one.

A copy of the written credit report with at least three years of history should be retained in the Approved Lender's file. However, a transcript of a credit report obtained by telephone would be sufficient. For self-employed borrowers, a credit report on the business should also be obtained.

In analysing the credit report, it is important to identify any discrepancies between it and the information given by the borrower in the application and other documentation. Follow-up is necessary on any inconsistencies, inaccuracies, or omissions.

Where a bankruptcy record is disclosed, the applicant may not have been able to re-establish the necessary credit management and stability of income to qualify for a loan. Such re-establishment could take up to two to three years from the date of discharge. However, it would be useful to assess the reasons for any ongoing effects of the bankruptcy on the applicant's ability to repay.

In cases where mortgage funds are not advanced within a reasonable time of the initial underwriting review, underwriters should retain the right to complete another financial analysis, including the obtaining of a current file credit report immediately prior to funding the mortgage.

## Net Worth

A net worth statement should be received and analysed as a standard part of assessing the borrower's eligibility. Although a net worth statement is simply a snapshot at a given point in time, such analysis provides an indication of a borrower's financial know-how and may offset other negative factors. It also provides clues about debts which may not be indicated in a credit report. Applicants should be questioned on large or recently acquired assets for which no debt is indicated.

## Non-Residents of Canada

Mortgage loans are normally available only to borrowers who are permanent residents of Canada. Exceptions may be considered on a case-by-case basis.

## Guarantors

Occasionally, loan applications are received for which the applicant's financial situation is not considered to be sufficient to warrant approval. An additional guarantee may also be obtained in order to approve the loan. In such cases, an assessment of the financial capacity of the guarantor should be made.



## CMHC Information Products

In order to serve you better, the following CMHC information products are available to you or your clients. We hope that they will be a valuable source of information.

### For you

#### **Administrative Guide – Default Management and Claims**

NHA 5557/LNH 5558

#### **Administrative Guide – Application Processing for Home Ownership Mortgage Loan Insurance**

NHA 5552/LNH 5553

#### **Quick Reference Guide – Mortgage Loan Insurance**

NHA 5882/LNH 5883

#### **The CMHC Alternative for Multiples (Pamphlet)**

NHA 6693/LNH 6694

#### **CMHC's Approach to Mortgage Underwriting for Residential Multiples**

NHA 6965/LNH 6966

#### **Pocket Guide – Mortgage Loan Insurance**

NHA 5582/LNH 5583

### For your customers

#### **Mortgage Loan Insurance – Welcome Home**

NHA 6811/LNH6812

#### **The Complete Guide to Buying Your Home\***

NHA 6953/LNH 6954

#### **How to Lock Out Crime\***

NHA 6923/LNH 6924

#### **Home Care\***

NHA 5624/LNH 5625

#### **Inspection Checklist for Maintenance and Repair\***

NHA 5731/LNH 5732

#### **The Clean Air Guide\***

NHA 6695/LNH 6696

#### **This Clean House Video\***

VE057/VF057

#### **AffordAbility Software\***

(coming soon)

\*Priced information products

**Note:** LNH numbers refer to the French version of each publication.

For more information or for a copy of our Information Products Catalogue, please call **1-800-668-2642**.









# There are 28 CMHC Offices from Coast to Coast to serve you:

## NEWFOUNDLAND QUEBEC

### St. John's

Tel. (709) 772-4400

Fax (709) 726-1166

## PRINCE EDWARD ISLAND

### Charlottetown

Tel. (902) 566-7336

Fax (902) 566-7350

## NOVA SCOTIA

### Halifax

Tel. (902) 426-3530

Fax (902) 426-9991

## NEW BRUNSWICK

### Fredericton

Tel. (506) 452-3050

Fax (506) 451-6066

### Chicoutimi

Tel. (418) 698-5511

Fax (418) 698-5519

### Hull

Tel. (819) 770-1550

Fax (819) 770-5278

### Laval

Tel. (514) 967-3700

Fax (514) 663-9376

### Montréal

Tel. (514) 283-2222

Fax (514) 283-0404

### Québec City

Tel. (418) 649-8080

Fax (418) 649-8099

### Sherbrooke

Tel. (819) 564-4220

Fax (819) 564-4281

## ONTARIO

### Hamilton

Tel. (905) 527-2642

Fax (905) 572-2413

### London

Tel. (519) 438-1731

Fax (519) 438-0029

### Oshawa

Tel. (905) 571-3200

Fax (905) 571-1523

### Ottawa

Tel. (613) 748-2000

Fax (613) 748-5130

### Sudbury

Tel. (705) 523-2900

Fax (705) 522-5700

### Thunder Bay

Tel. (807) 343-2010

Fax (807) 345-0696

### Toronto

Tel. (416) 781-2451

Fax (416) 781-4473

## MANITOBA

### Winnipeg

Tel. (204) 983-5600

Fax (204) 983-8046

## SASKATCHEWAN

### Regina

Tel. (306) 780-5880

Fax (306) 780-8800

### Saskatoon

Tel. (306) 975-4900

Fax (306) 975-6066

## ALBERTA

### Calgary

Tel. (403) 292-6200

Fax (403) 292-6250

### Edmonton

Tel. (403) 482-8700

Fax (403) 482-8777

## NORTHWEST TERRITORIES

### Yellowknife

Tel. (403) 873-2637

Fax (403) 873-3922

## BRITISH COLUMBIA

### Kelowna

Tel. (250) 861-6049

Fax (250) 861-6054

### Prince George

Tel. (250) 561-5433

Fax (250) 561-5444

### Vancouver

Tel. (604) 731-5733

Fax (604) 737-4122

### Victoria

Tel. (250) 995-3400

Fax (250) 995-2641

## YUKON

### Whitehorse

Tel. (403) 633-7530

Fax (403) 633-7542

You can also visit us on the Internet at [www.cmhc-schl.gc.ca](http://www.cmhc-schl.gc.ca)

CMHC subscribes to the sustainable development theme of the federal government. Quantities of our publications are limited to market demand; updates are produced only when required; and recycled or environmentally friendly stock and environmentally safe inks are used whenever possible.

